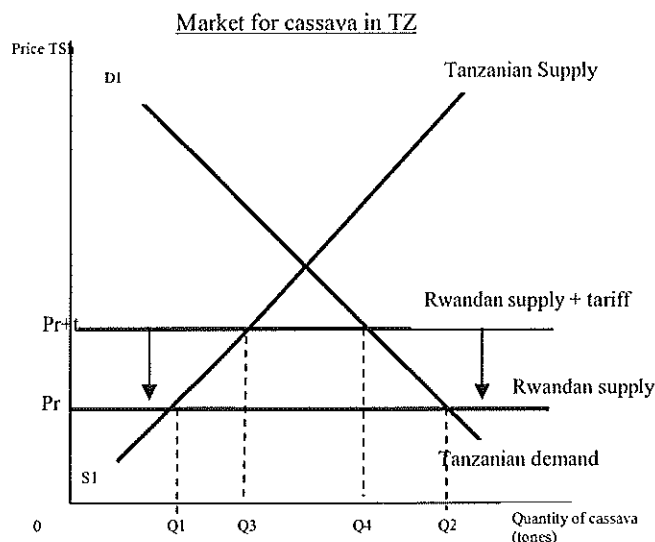


## HIGHER LEVEL: TRADE CREATION AND TRADE DIVERSION

**Trade creation** occurs when the entry of a country into a customs union leads to the production of a good or service transferring from a high cost producer to a low cost producer. This is a key advantage of economic integration.

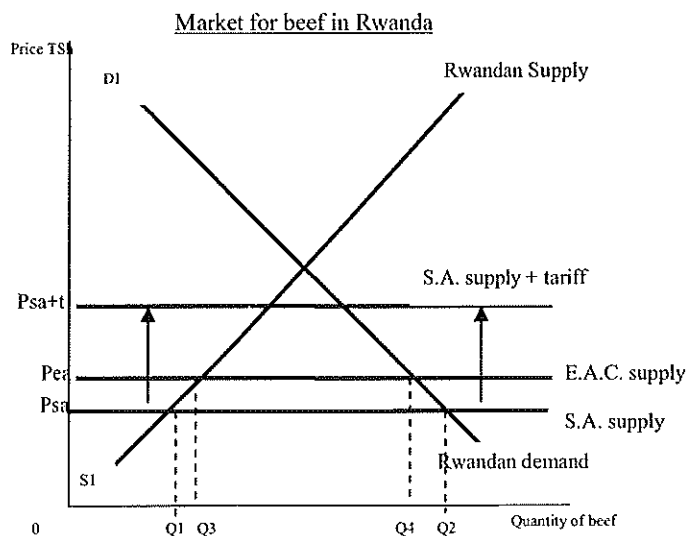
Let us assume that Rwanda has a comparative advantage in the production of cassava over Tanzania. Before Rwanda joined the EAC, tariffs were placed on the imports of its cassava into the EAC. Refer to the diagram below:



With the tariff in place, Tanzania will produce \_\_\_\_\_ and will import \_\_\_\_\_ from Rwanda. Upon entering the EAC the tariff is removed and Rwanda can make full use of its comparative advantage. Imports will rise to \_\_\_\_\_ and Tanzanian production will fall to \_\_\_\_\_. There is more cassava being bought and sold now so trade has been *created*. In addition, the extra demand means there has been an increase in consumer surplus.

There is also a movement from a high cost producer \_\_\_\_\_ to a low cost producer \_\_\_\_\_ and there is a world welfare gain as fewer resources are being used to produce cassava.

**Trade diversion** occurs when the entry of a country into a customs union leads to the production of a good or service transferring from a low-cost producer to a high cost producer. This is a disadvantage of greater economic integration.



Before entering the E.A.C., Rwanda traded freely with S.Africa. S.Africa is a more efficient producer of beef and therefore was able to supply beef on to the Rwandan market at the low price of \_\_\_\_\_. At that price S.African imports are \_\_\_\_\_ and Rwandan producers supply \_\_\_\_\_. Upon entering the EAC, Rwanda is forced to adopt the common external tariff on beef from S.A. The S.African supply curve shifts up by the value of the tariff and its beef is now more expensive than beef from other EAC countries. Rwandan producers will supply \_\_\_\_\_ on to the market and imports of \_\_\_\_\_ will come from the \_\_\_\_\_. There has been an overall fall in the quantity produced and consumed of beef and a switch from a low cost producer like \_\_\_\_\_ to high cost producers in the \_\_\_\_\_. There is a fall in world economic welfare.